STATE OF MICHIGAN

COURT OF APPEALS

KILPATRICK BROTHERS PAINTING,

Plaintiff/Third-Party Plaintiff/Counter-Defendant,

v

CHIPPEWA HILLS SCHOOL DISTRICT,

Defendant/Counter-Plaintiff/Third-Party Plaintiff-Appellant,

and

MERCHANTS BONDING COMPANY,

Third-Party Defendant/Cross-Plaintiff-Appellee,

and

RALPH KILPATRICK, ARTHUR W. KILPATRICK, and SONDRA L. KILPATRICK,

Cross-Defendants,

and

SEVENS PAINT AND WALLPAPER COMPANY and BENJAMIN MOORE AND COMPANY,

Third-Party Defendants.

UNPUBLISHED
March 16, 2006

No. 262396
Mecosta Circuit Court
LC No. 03-016073-CK

Before: Murphy, P.J., and White and Meter, JJ.

PER CURIAM.

Defendant Chippewa Hills School District ("the school district") appeals by leave granted from an order granting summary disposition to third-party defendant Merchants Bonding Company ("Merchants") under MCR 2.116(C)(10). We reverse.

The school district contracted with plaintiff, Kilpatrick Brothers Painting, to paint the school district's new intermediate school building. Plaintiff provided a statutory performance bond, see MCL 129.201 *et seq.*, which was underwritten by Merchants. After the school district noticed problems with the painting work, which involved metal roof decking inside the gymnasium, and plaintiff refused to correct the problems, the school district hired another contractor to correct the problems and complete the project. Plaintiff subsequently brought this action against the school district, which then filed a third-party complaint against Merchants under the performance bond. The trial court determined that the school district failed to comply with requirements of the performance bond necessary to trigger Merchants's liability and, accordingly, granted Merchants's motion for summary disposition and dismissed the school district's third-party complaint.

A trial court's grant of summary disposition is reviewed de novo, using the entire record, to determine whether the prevailing party was entitled to judgment as a matter of law. *Maiden v Rozwood*, 461 Mich 109, 118; 597 NW2d 817 (1999). When reviewing a motion for summary disposition brought under MCR 2.116(C)(10), the trial court must examine the documentary evidence presented and, drawing all reasonable inferences in favor of the nonmoving party, determine whether a genuine issue of material fact exists. *Quinto v Cross & Peters Co*, 451 Mich 358, 361-362; 547 NW2d 314 (1996). Only "the substantively admissible evidence actually proffered" may be considered. *Maiden*, *supra* at 121.

The school district argues that it did not violate the terms of the performance bond by exercising its contractual right to correct and complete plaintiff's work. Our analysis of this issue requires that we examine the terms of the performance bond and the underlying construction contract between plaintiff and the school district.

"In interpreting a contract, [a court's] obligation is to determine the intent of the contracting parties." *Quality Products & Concepts Co v Nagel Precision, Inc*, 469 Mich 362, 375; 666 NW2d 251 (2003). If contract language is clear and unambiguous, its construction is a question of law for the court. *Klapp v United Ins Group Agency, Inc*, 468 Mich 459, 469; 663 NW2d 447 (2003); *Michigan Nat'l Bank v Laskowski*, 228 Mich App 710, 714; 580 NW2d 8 (1998). Unambiguous language is reflective of the parties' intent as a matter of law and is enforced as written, unless it is contrary to public policy. *Quality Products*, *supra* at 375. On the other hand, if an ambiguity is found, its meaning is a question of fact that must be decided by the trier of fact. *Klapp*, *supra* at 469. A "'contract is ambiguous when its provisions are capable of conflicting interpretations.'" *Id.* at 467, quoting *Farm Bureau Mut Ins Co v Nikkel*, 460 Mich 558, 566; 596 NW2d 915 (1999). "[C]ourts must . . . give effect to every word, phrase, and clause in a contract and avoid an interpretation that would render any part of the contract surplusage or nugatory." *Id*. at 468.

The general conditions document of the construction contract between plaintiff and the school district includes provisions that, in pertinent part, make the contractor (plaintiff) liable to the owner (the school district) for the cost of correcting defective work (§§ 12.2.1 and 12.2.4)

and for the cost of completing the work (§ 14.2.4). The construction contract does not require notice to the surety.

The school district argues that, under the general conditions, it was free to charge plaintiff for the cost of correcting and completing its work, less the contract balance, and that, once plaintiff was defaulted and terminated as provided in the bond, Merchants became liable for any amounts owed by plaintiff. Merchants argues that it is only liable for costs incurred *after* proper default and termination, not for prior charges owed by plaintiff or for charges incurred without affording it an opportunity to complete the work under ¶ 4 of the bond.

As previously noted, the general conditions of the construction contract allow an owner to correct and complete a contractor's defective work, at the contractor's expense. Section 2.4.1 states that the owner may undertake such corrections "without prejudice to other remedies the Owner may have . . . ." Similarly, § 14.2.2.3 allows an owner to terminate a contractor "without prejudice to any other rights or remedies of the Owner, . . . [but] subject to any prior rights of the surety," and to then "finish the Work by whatever reasonable method the Owner may deem expedient." Section 14.2.4 states that the "obligation for payment shall survive termination of the Contract."

Significantly, if we accept Merchants's position that it is not liable for any costs assessed against plaintiff before plaintiff's default and termination, it would render meaningless the contractual provisions that allow an owner to undertake these remedies "without prejudice" to other remedies available.

Further, ¶ 1 of the performance bond incorporates the construction contract by reference and states that Merchants is "jointly and severally liable" with plaintiff "for the performance of the Construction Contract." This is in accord with Michigan cases holding that a surety's obligations are coextensive with its principal's obligations under the contract. See *In re MacDonald Estate*, 341 Mich 382, 387; 67 NW2d 227 (1954); see also *Will H Hall & Son, Inc v Ace Masonry Construction, Inc*, 260 Mich App 222, 229; 677 NW2d 51 (2003). When a construction contract is incorporated by reference into a performance bond, the two are to be read together. *Hunters Pointe Partners Ltd Partnership v United States Fidelity & Guaranty Co*, 194 Mich App 294, 297; 486 NW2d 136 (1992). "Therefore, if the principal can be held liable for breach of a construction contract, so may the surety." *Id*. at 298 n 2.

Under the clear terms of the bond, Merchants is liable for *all* of plaintiff's obligations under the contract. This includes plaintiff's contractual obligation to pay the costs of correcting and completing its work, above the contract balance. In particular, ¶ 6.1 of the bond expressly states that Merchants is liable for the cost of correcting and completing the contractor's work, above the contract balance, and ¶ 6.3 makes Merchants liable for liquidated or actual damages caused by the contractor's default or nonperformance.[1] Therefore, we conclude that under the

[1] While the first sentence of ¶ 6 is limited to cases in which the surety elects to complete the work under ¶¶ 4.1, 4.2 or 4.3, the last sentence is not so limited. Therefore, even if the contractor (or its surety) completes the work, the surety may be liable under ¶ 6.3 for additional
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terms of the performance bond, a surety's liability is not limited to costs incurred after default and termination of the contractor.

Merchants argues that the school district failed to comply with the bond's notice requirements. We disagree.

In letters dated March 2 and March 13, 2002, the school district demanded that plaintiff cure its defective work. The letters also gave notice to plaintiff (and Merchants) that if plaintiff failed to perform, the school district would hire another contractor to correct plaintiff's work, as permitted by § 2.4.1 of the construction contract. On March 19, 2002, the school district sent plaintiff and Merchants a letter expressing its intent to declare plaintiff in default. The letter also requested a conference with plaintiff and Merchants, as permitted by ¶ 3.1 of the bond.

On April 26, 2002, the school district sent plaintiff (and Merchants) a letter terminating plaintiff's contract and offering to pay the balance of the contract price to Merchants or to a contractor selected to finish the work, in accordance with the terms of the contract. Thus, the letter complied with the bond's termination requirement in ¶ 3.2 and with the requirement of ¶ 3.3 that the school district offer to pay the contract balance to the surety (or another contractor). Although the letter does not specifically state that the school district was declaring plaintiff in default, Merchants's claims' attorney agreed that – apart from the issue of whether completion contractors could be hired before default and termination – the letter satisfied the requirements of ¶¶ 3.2 and 3.3. Thus, under ¶ 4, Merchants was obligated to "promptly" undertake one of the options listed.

Merchants argues that, because the school district had already hired contractors to correct and complete plaintiff's work, it was deprived of the right to perform under ¶¶ 4.1, 4.2, and 4.3 of the bond. Therefore, it argues, its obligations under the bond were discharged.

In *Will H Hall & Son, Inc*, *supra* at 231, this Court recognized that "Michigan case law is minimal concerning sureties . . . ." Thus, the Court sought guidance in the Restatement Suretyship and Guaranty, 3d ("the Restatement"). *Will H Hall & Son, Inc*, *supra* at 231.

While Merchants suggests that this is a settled area of the law, the introductory note to the Restatement, § 36, p 156, states that "[t]here is probably no area of suretyship law in which there is less consensus than the law of suretyship defenses." Because "[r]ules vary from jurisdiction to jurisdiction, from context to context, and from common law to the Uniform Commercial Code," the Restatement "seeks to rationalize this complex area and to set forth a series of rules that flow from a common concept." *Id*. According to the Restatement, the general rule is that if the obligee (the school district) does something that changes the risks undertaken by the secondary obligor (Merchants) as surety for the principal obligor (plaintiff), "there is the potential for a loss to the secondary obligor" that may result in the discharge of the secondary obligor's obligation under the bond. *Id*. at 157.

(…continued)

damages caused by the contractor's delay.

In the present case, Merchants seeks to be excused from its obligations under the performance bond because the school district hired contractors to correct and complete plaintiff's work before default and termination, and this, Merchants alleges, affected its ability to perform (and mitigate its damages) under ¶ 4. However, this circumstance is not among those recognized in the Restatement, § 37, that might result in the discharge of a surety's obligation.[2] In particular, the school district did not alter Merchants's risks as defined in the Restatement, §§ 37(2), 39(c)(iii), and 41(b)(i), because it neither released plaintiff from its duties[3] nor modified plaintiff's duties. Similarly, the school district did not violate the Restatement, §§ 37(3), 39(c)(ii), 40(b), and 41(b)(ii), because it did not impair Merchants's recourse against plaintiff. Thus, Merchants does not have a defense against the school district under the Restatement, § 37(4).

In this case, the school district hired contractors to correct and complete plaintiff's work as permitted by the clear terms of §§ 2.4.1, 14.2.2.3, and 14.2.4 of the construction contract. If Merchants were permitted to avoid its bond obligations on that basis, the school district's ability to pursue other remedies would be impaired, contrary to the clear language of §§ 2.4.1 and 14.2.2 of the construction contract. Nonetheless, Merchants urges this Court to follow cases from other jurisdictions holding that hiring completion contractors before notice of default and termination deprives the surety of the bond-given opportunity to complete the work and mitigate damages. The cases cited by Merchants hold that doing so is a material breach of the bond that discharges the surety and that prejudice to the surety's interests must be presumed. See *Elm Haven Constr Ltd Partnership v Neri Constr, LLC*, 376 F3d 96, 100-101 (CA 2, 2004); *School Bd of Escambia Co v TIG Premier Ins Co*, 110 F Supp 2d 1351, 1353-1354 (ND Fla, 2000); *Ins Co of North America v Metropolitan Dade Co*, 705 So 2d 33, 34-35 (Fla Dist Ct App, 1997); and *Dragon Constr, Inc v Parkway Bank & Trust*, 287 Ill App 3d 29, 33-34; 678 NE2d 55 (Ill App, 1997); see also *Seaboard Surety Co v Town of Greenfield*, 370 F3d 215, 219-220, 222-224 (CA 1, 2004) and *Int'l Fidelity Ins Co v Co of Rockland*, 98 F Supp 2d 400, 421 (SD NY, 2000) (explicitly applying the doctrine of *strictissimi juris*).[4]

We decline to follow cases from other jurisdictions that allow a surety's responsibilities to be discharged for technical violations of the bond. As previously discussed, the school district's alleged impairment of Merchants' ability to perform does not meet the requirements of the Restatement, § 37. As supported by the comments to § 37, where Merchants cannot show a serious impairment or any resulting harm, excusing it from its obligations under the bond would bestow upon it an unwarranted windfall – at taxpayers' expense.

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[2] The Restatement, § 37, with its comments, summarizes the surety defenses and other principles discussed in the rest of the chapter.

[3] Because default and termination of the contractor are prerequisites to Merchants's liability under the bond, terminating plaintiff cannot reasonably be considered a release of the principal obligor under the Restatement, § 37(2)(a).

[4] The doctrine of *strictissimi juris* holds that "any act of the obligee that varied the secondary obligor's risk automatically discharged the secondary obligor." Restatement, § 37, comment a, p 159.

Michigan's minimal surety law, like the Restatement, holds that "[b]onds of sureties for hire are more strictly construed against them than are bonds against gratuitous sureties." *Detroit v Blue Ribbon Auto Drivers' Ass'n*, 254 Mich 263, 266; 237 NW 61 (1931). "[A] corporation engaged in the business of becoming surety for compensation . . . . is not a gratuitous surety and may not invoke the rule of *strictissimi juris*." *Sandusky Grain Co v Borden's Condensed Milk Co*, 214 Mich 306, 311; 183 NW 218 (1921). A surety is bound by the terms of the bond, as written. *Detroit*, *supra* at 266. Additionally, the bond is to be read with the underlying contract and, "if the principal can be held liable for breach of a construction contract, so may the surety." *Hunters Pointe* , *supra* at 297, 298 n 2.

In Michigan, "[t]he . . . obligation as a surety for hire is in the nature of insurance; 'and courts in the construction of its contracts usually invoke rules applicable to contracts of insurance.'" *Detroit*, *supra* at 266, quoting *Sandusky Grain Co*, *supra* at 311; see also *Gen Electric Credit Corp v Wolverine Ins Co* (*Gen Electric I*), 120 Mich App 227, 233-234; 327 NW2d 449 (1982), aff'd 420 Mich 176; 362 NW2d 595 (1984) (*General Electric II*). In the context of insurance policies,

> it is a well-established principle that an insurer who seeks to cut off responsibility on the ground that its insured did not comply with a contract provision requiring notice immediately or within a reasonable time must establish actual prejudice to its position. [*Koski v Allstate Ins Co*, 456 Mich 439, 444; 572 NW2d 636 (1998).]

Accordingly, in the surety context, "[a] paid surety must demonstrate that it has been prejudiced before it will be released from its contract of guarantee." *Miller Industries, Inc v Cadillac State Bank*, 40 Mich App 52, 59; 198 NW2d 433 (1972); see also *Nelson & Son, Inc v Atlas Concrete Pipe, Inc*, 84 Mich App 29, 32-33; 269 NW2d 295 (1978). "It is not enough that there is a deviation from the terms of the contract, but it must be a material deviation with a paid surety, and one which results in injury to it in order to release it from liability." *Bernadich v Bernadich (Lincoln Mut Cas Co)*, 287 Mich 137, 144; 283 NW 5 (1938), quoting *Realty Constr Co v Kennedy*, 234 Mich 490, 495; 208 NW 455 (1926).

Moreover, in the present case, the bond furnished by Merchants was "conditioned upon the faithful performance of the contract in accordance with the plans, specifications and terms thereof." MCL 129.202. Additionally, "[t]he bond shall be solely for the protection of the governmental unit awarding the contract." *Id*. The bond protects the governmental unit by ensuring that, "[i]f a general contractor or a subcontractor defaults on a project, the governmental unit will have economic recourse to guarantee that the project is completed." *W T Andrew Co, Inc v Mid-State Surety Corp*, 450 Mich 655, 668; 545 NW2d 351 (1996).

As the school district argues, the bond does not guarantee that, at the time of default and termination, all of the options listed in ¶ 4 will be available. Merchants is bound by the terms of the bond, as written. *Blue Ribbon*, *supra* at 266.

In determining whether the school district committed a material violation of the bond that resulted in injury to Merchants, we note that, in letters dated March 2, March 13, and March 19, 2002, the school district notified plaintiff (with copies to Merchants), that it intended to hire replacement contractors if plaintiff did not correct its work and asked both plaintiff and

Merchants to participate in a conference on March 22, 2002. Merchants did nothing. On April 26, 2002, the school district terminated plaintiff and offered to pay the contract balance to Merchants (or another contractor), thus satisfying ¶¶ 3.2 and 3.3 of the bond.

The trial court noted Merchants's inaction, commenting, "And why would they not be able to do that if they wanted to lay in the bushes and wait for you to screw up?" However, allowing Merchants to benefit from such conduct would be inconsistent with the bond's purpose of protecting the school district and, ultimately, would result in granting it an unwarranted windfall.

As of its May 6, 2002, letter to the school district, Merchants was admittedly aware that repair and completion work was already underway. However, Merchants did not attempt to arrange for plaintiff to complete the work (¶ 4.1), did not request to perform the work itself or through contractors (¶ 4.2), and did not attempt to obtain bids for completing the work (¶ 4.3). Instead, Merchants indicated that it was "investigating the matter under a complete reservation of rights." Meanwhile, the school district was faced with the reality that delays occasioned by plaintiff's work could forestall the beginning of the 2002-2003 school year.

Under all the circumstances, we conclude that by electing to investigate without objection, Merchants effectively made a choice to proceed under ¶ 4.4 of the bond. Therefore, the school district's hiring of repair and completion contractors (in accordance with the construction contract) was not a material breach of the bond. Additionally, even if the school district breached the bond, Merchants failed to come forth with any evidence of resulting prejudice. Thus, the trial court erred in finding that Merchants was absolved of its obligations under the bond.

Merchants argues that the school district failed to give it the additional notice required by ¶ 5 before hiring other contractors. Therefore, Merchants argues, the school district breached the bond and discharged Merchants from its obligations – providing an alternative basis for affirming the trial court's decision. Merchants also argues that its June 20, 2003, letter acknowledging liability in the amount of $63,083.37 is a settlement offer, which is inadmissible under MRE 408.

Paragraph 4.4 of the bond clearly requires that, "with reasonable promptness," Merchants either deny liability (¶ 4.4.2), or, "[a]fter investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment . . . ." (¶ 4.4.1). Additionally, under ¶ 5, if Merchants

> does not proceed as provided in Paragraph 4 with reasonable promptness, the Surety shall be deemed in default on this Bond *fifteen days after* receipt of an *additional written notice* from the Owner to the Surety *demanding that the Surety perform its obligations under this Bond*, and the Owner shall be entitled to enforce any remedy available to the Owner. [Emphasis added.]

However, if Merchants "proceeds as provided in Subparagraph 4.4, and the Owner refuses *the payment tendered or the Surety has denied liability,* in whole or in part, *without further notice* the Owner shall be entitled to enforce any remedy available to the Owner" (emphasis added).

As discussed previously, the school district had satisfied the requirements of ¶ 3 as of April 26, 2002, and Merchants effectively chose to investigate the claim under ¶ 4.4. As of August 2003, however, the school district's claim remained unpaid, pending Merchants's ongoing investigation. We therefore conclude that Merchants failed to proceed "with reasonable promptness," contrary to ¶ 4.4, thus triggering the requirement of additional notice under ¶ 5. The school district satisfied this requirement of additional notice by letters dated August 20 and November 18, 2003, demanding payment of its claim.[5] Therefore, it is unnecessary to address the admissibility of Merchants's June 20, 2003, letter.[6]

In sum, we conclude that the school district did not commit a material breach of the performance bond that caused injury to Merchants and, therefore, Merchants was not entitled to be discharged from its obligations under the bond. The trial court erred in granting Merchants's motion for summary disposition.

Reversed.

/s/ Helene N. White
/s/ Patrick M. Meter

I concur in result only.

/s/ William B. Murphy

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[5] Merchants argues that demanding payment of its claim is not a demand that it "perform its obligations under this Bond." Given the payment obligations listed in ¶ 6 of the bond, however, we conclude that Merchants's position is without merit.

[6] We note, however, that under MRE 408, an offer of compromise is admissible for purposes *other than* proving liability (or the invalidity of a claim). See *Price v Long Realty, Inc*, 199 Mich App 461, 466; 502 NW2d 337 (1993). Whether the letter was an offer of compromise is a preliminary question reserved to the trial court under MRE 104(a).